

## University of Miami Law School University of Miami School of Law Institutional Repository

---

University of Miami Business Law Review

---

12-19-2018

# The Howey Test: Are Crypto-Assets Investment Contracts?

Justin Henning

Follow this and additional works at: <https://repository.law.miami.edu/umblr>

 Part of the [Law and Economics Commons](#), and the [Securities Law Commons](#)

---

### Recommended Citation

Justin Henning, *The Howey Test: Are Crypto-Assets Investment Contracts?*, 27 U. Miami Bus. L. Rev. 51 ()  
Available at: <https://repository.law.miami.edu/umblr/vol27/iss1/6>

This Note is brought to you for free and open access by University of Miami School of Law Institutional Repository. It has been accepted for inclusion in University of Miami Business Law Review by an authorized editor of University of Miami School of Law Institutional Repository. For more information, please contact [library@law.miami.edu](mailto:library@law.miami.edu).

# The Howey Test: Are Crypto–Assets Investment Contracts?

Justin Henning<sup>\*</sup>

*With innovation always comes unknowns. Blockchain technology and crypto–assets are no different. Often times, innovators are so worried about getting their product to market or scaling at mass that they overlook the legal ramifications of their innovations. As Mark Zuckerberg infamously said, “move fast and break things.” Facebook was in no way alone in this style of innovation. However, with respect to crypto–assets, the SEC has stepped in and is attempting to prevent the “break things” aspect. One of the major issues relating to crypto–assets is that many people still do not understand what they are, or how the underlying technology works. At the moment, we do not know what to classify crypto–assets as: property, commodities, or something else.*

*If the SEC determines that crypto–assets are investment contracts, the regulation that follows is at risk of putting stranglehold on the underlying innovation and technology. It becomes an issue of balancing consumer protection and innovation for society. SEC v. W.J. Howey Co. laid out a pronged test to determine whether a transaction is an investment contract, subjecting it to securities laws. This note examines the Howey Test to explain why two popular crypto–assets, Bitcoin and Ethereum, are unlikely to satisfy the Howey Test, and briefly addresses the need for clarity in this area.*

---

<sup>\*</sup> Articles and Comments Editor, University of Miami Business Law Review; Juris Doctor Candidate 2019, University of Miami School of Law; Bachelor of Arts in Political Science 2016, University of South Florida. I would like to personally thank the Editorial Board of the University of Miami Business Law for all of their hard work and diligence. I would also like to specifically thank Professor Daniel B. Ravicher for his knowledge and guidance throughout the entirety of this process.

I.	INTRODUCTION .....	52
II.	CRYPTO-ASSETS 101.....	53
	A. <i>Bitcoin</i> .....	56
	B. <i>Ethereum</i> .....	57
III.	ALONG CAME HOWEY .....	60
IV.	UNDERSTANDING THE <i>HOWEY</i> TEST .....	61
	A. <i>Investment of Money in a Common Enterprise</i> .....	61
	a. Interpretations .....	61
	b. Analysis.....	65
	B. <i>Profits Solely from the Efforts of Others</i> .....	68
	a. Interpretations .....	68
	b. Analysis.....	70
V.	CONCLUSION.....	71

## I. INTRODUCTION

On July 25, 2017, the Securities and Exchange Commission (“SEC”) released an investigative report warning that “[o]ffers and sales of digital assets by ‘virtual’ organizations are subject to the requirements of the federal securities laws.”<sup>1</sup> After a bold opening statement, the SEC pulled back the statement and stated “[w]hether a particular investment transaction involves the offer or sale of a security . . . will depend on the facts and circumstances . . . of the transaction.”<sup>2</sup> The statement was released in the aftermath of the SEC’s determination that the Decentralized Autonomous Organization (“DAO”)<sup>3</sup> tokens qualified as securities, rendering them liable to securities laws.<sup>4</sup> Many emerging companies and startups rely on digital tokens and crypto-assets to fund their projects. Because of the SEC’s vague warning, companies are unsure whether crypto-assets will subject them to penalties or criminal charges.

This note will examine the Supreme Court case of *SEC v. W.J. Howey Co.* to explain why two popular crypto-assets likely do not satisfy the

---

<sup>1</sup> *SEC Issues Investigative Rep. Concluding DAO Tokens, a Digital Asset, Were Securities*, SEC. AND EXCHANGE COMMISSION (July 25, 2017), <https://www.sec.gov/news/press-release/2017-131>.

<sup>2</sup> *Id.*

<sup>3</sup> *What is a DAO?* COINDESK.COM, <https://www.coindesk.com/information/what-is-a-dao-ethereum/>.

<sup>4</sup> *Id.*

*Howey* two-factor test of being an investment contract.<sup>5</sup> Part II of this note will explain the history and technology behind two popular crypto-assets, Bitcoin and Ethereum. Part III will analyze *Howey* by examining the facts and opinions of the Court.<sup>6</sup> Part IV will examine how United States courts have understood the factors established in *Howey*, as applied to Bitcoin and Ethereum, and concluded that the *Howey* two-factor test is likely inapplicable and therefore should not be subject to federal securities laws.<sup>7</sup> Finally, Part V summarizes the arguments put forth and presents hypothetical courses of action the SEC may take in the future with respect to crypto-assets.

## II. CRYPTO-ASSETS 101

Crypto-assets, commonly known as cryptocurrencies, exist in digital form on the internet for the purpose of being distributed from person to person without a bank or other governing body's oversight.<sup>8</sup> The term crypto-asset will be used in place of cryptocurrency throughout this note because the term "currency" denotes a legal conclusion, and there are many different uses of crypto-assets other than as purely currency. Crypto-assets often receive the negative publicity of being used to fund illegal transactions on the Dark Web.<sup>9</sup> Therefore, as crypto-assets become more popular, they are often fighting an uphill battle against their perceived user base.<sup>10</sup>

The decentralization of crypto-assets means that there is no central bank or governing body that regulates or backs the currency.<sup>11</sup> When a currency is backed and controlled by a government, also known as fiat currency, "[g]overnments are able to influence the value of their

---

<sup>5</sup> SEC v. W.J. Howey Co., 328 U.S. 293, 298-99 (1946) (holding that a transaction deemed to be an investment contract is subject to federal securities laws).

<sup>6</sup> *Id.* at 293-302.

<sup>7</sup> *See id.* at 298-99 (establishing a two-factor test to determine whether a transaction qualifies as an investment contract).

<sup>8</sup> *See* Timothy Bierer, *Hashing It Out: Problems and Solutions Concerning Cryptocurrency Used as Article 9 Collateral*, 7 CASE W. RESERVE J.L. TECH. & INTERNET 79, 81 (2016) (defining cryptocurrencies).

<sup>9</sup> *See* Stephen T. Middlebrook & Sarah Jane Hughes, *Regulating Cryptocurrencies in the United States: Current Issues and Future Direction*, 40 WM. MITCHELL L. REV. 813, 818-19 (2014) (explaining that Bitcoin has been "strongly suspected of being associated" with "an online marketplace for drugs, erotica, fake IDs, and other illegal goods.").

<sup>10</sup> *See id.* (citations omitted).

<sup>11</sup> *See, e.g.,* Matthew Kien-Meng Ly, Comment, *Coining Bitcoin's "Legal-Bits": Examining The Regulatory Framework for Bitcoin and Virtual Currencies*, 27 HARV. J. LAW & TEC 587, 590 (2014).

currencies” resulting in a “[r]elatively stable currency.”<sup>12</sup> Crypto-assets, not being backed by a nation or commodity, means that “[t]he value of a bitcoin [or any decentralized crypto-asset] is determined solely by public perception, trust, and adoption.”<sup>13</sup> Therefore, a decentralized crypto-asset is inherently volatile and potentially risky.<sup>14</sup> In general, “[p]eople and businesses are hesitant to use crypto-assets in transactions, as it is unknown whether the value of the currency will drastically ascend or descend: just take the tale of the multimillion-dollar pizza.”<sup>15</sup>

Notably, many institutional investors have been hesitant about getting into crypto; however, proposed Bitcoin exchange-traded funds (“ETFs”) are “[s]een as a way for institutional investors to get into [crypto-asset] investing in a safer way than buying bitcoin on a crypto-asset exchange.”<sup>16</sup> ETFs can be traded on a market and track a commodity or asset.<sup>17</sup> More specific, ETFs traded on markets track indexes that follow the S&P 500 or the Nasdaq 100.<sup>18</sup> Put simply, ETFs main benefit in terms of crypto-assets is that it simplifies the process for those who may not understand the technology.<sup>19</sup> Especially, “the actual bitcoins [like gold bars or oil in a commodities ETF] would remain under the control of a custodian, who bundles them together and issues representative shares.”<sup>20</sup> However, on August 8, 2018, the SEC delayed its decision on a Bitcoin ETF, causing the price of Bitcoin to fall drastically.<sup>21</sup> Many ETFs would lower the barrier to entry in crypto-assets, causing a flood of money into crypto; however, “[t]he SEC has been dragging its feet.”<sup>22</sup>

---

<sup>12</sup> Fiat Money, *Financial Times Lexicon*, <http://lexicon.ft.com/Term?term=fiat-money>.

<sup>13</sup> See Kien-Meng Ly, *supra* note 11, at 590.

<sup>14</sup> *Id.*

<sup>15</sup> See Rob Price, *Someone in 2010 Bought 2 Pizzas with 10,000 Bitcoins – Which Today Would Be Worth \$20 Million*, BUS. INSIDER (May 22, 2017), <http://www.businessinsider.com/bitcoin-pizza-day-passes-2000-20-million-2017-5>.

<sup>16</sup> Arjun Kharpal, *Over \$9 billion wiped off bitcoin’s value after SEC postpones key decision on a cryptocurrency ETF*, CNBC (Aug. 8, 2018), <https://www.cnbc.com/2018/08/08/bitcoin-price-falls-after-sec-postpones-key-etf-decision.html>.

<sup>17</sup> Andrew Ancheta, *Will ETF Approval Really Lead To A Flood Of Crypto Cash?*, CRYPTOBRIEFING.COM (July 17, 2018), <https://cryptobriefing.com/will-etf-approval-really-lead-to-a-flood-of-crypto-cash/>.

<sup>18</sup> *Id.*

<sup>19</sup> See *id.*

<sup>20</sup> *Id.*

<sup>21</sup> See Kharpal, *supra* note 16.

<sup>22</sup> Kharpal, *supra* note 16; see also Ancheta, *supra* note 17 (discussing advantages of a Bitcoin ETF and how analyst predict an ETF would cause money to pour into to crypto).

One distinguishing feature of crypto-assets is the use of blockchain technology.<sup>23</sup> The blockchain is “[a] system that has numerous components which, when operating in conjunction with each other, can solve incredible problems across a broad array of industries . . . .”<sup>24</sup> Confused yet? To simplify a bit, “[b]lockchains tracking the transfer of virtual currency . . . maintain a similar ledger that keeps track of the transfer of Bitcoin from a transferor to a transferee.”<sup>25</sup> While this sounds similar to how many banks and countries track transactions, “[a] blockchain ledger is considered decentralized because transactions are stored on (several thousand) computers connected to a common network via the Internet,” called nodes.<sup>26</sup> This means that there is no single point of attack for a hacker to target, making it more secure than a centralized system.<sup>27</sup>

Many virtual currencies are produced via “mining,” a complicated process where users provide computing power to process Bitcoin or other crypto-asset transactions.<sup>28</sup> The result of a successful mine is the creation of “the next block in the blockchain.”<sup>29</sup> To successfully mine a block, the computer preforms an algorithm where it attempts to perform a math problem and guess a series of letters and numbers.<sup>30</sup> The purpose of mining these “blocks” is to record the ledger.<sup>31</sup> A transaction is not carried out until a miner records the transaction vis-a-vis a successfully mined block and is recorded on the ledger.<sup>32</sup> Users who mine earn transaction fees are paid in Bitcoins or other crypto-assets which motivate them to continue mining.<sup>33</sup> The miner whose computer can solve the given mathematical problem the fastest, adds the block to the blockchain and is rewarded.<sup>34</sup> The reason behind a mathematical algorithm that gets increasingly more difficult is to align “the incentives of miners with the security of the

---

<sup>23</sup> See SHAWN S. AMUIAL ET AL., *THE BLOCKCHAIN: A GUIDE FOR LEGAL & BUSINESS PROFESSIONALS* § 1:2, Westlaw (database updated October 2016) (explaining blockchain and its uses).

<sup>24</sup> *Id.*

<sup>25</sup> *Id.*

<sup>26</sup> *Id.* (alterations added).

<sup>27</sup> See Reuben Grinberg, *Bitcoin: An Innovative Alternative Digital Currency*, 4 HASTINGS SCI. & TECH. L.J. 159, 163 (2012).

<sup>28</sup> See *id.* (quotations omitted) (alterations added).

<sup>29</sup> See SHAWN S. AMUIAL ET AL., *THE BLOCKCHAIN: A GUIDE FOR LEGAL & BUSINESS PROFESSIONALS* § 1:3, Westlaw (database updated October 2016) (explaining the process of how blocks are added to the blockchain).

<sup>30</sup> See Noelle Acheson, *How Bitcoin Mining Works*, COINDESK.COM, <https://www.coindesk.com/information/how-bitcoin-mining-works> (last updated Jan. 29, 2018).

<sup>31</sup> See *id.*

<sup>32</sup> See *id.*

<sup>33</sup> See *id.*

<sup>34</sup> *Id.*

network.”<sup>35</sup> The main security threat with mining becoming too easy is called a 51% attack.<sup>36</sup> A 51% attack is a hypothetical attack where a miner, or group of miners, control more than 50% of the networks computing power, and thus win the race to mine the block every time.<sup>37</sup> The risk here is that these miners would control whether any transaction was recorded on the ledger and could “halt payments between some or all users.”<sup>38</sup> Further, they could carry out the digital equivalent of counterfeiting, known as “double-spending” where “[t]hey can send a transaction, then reverse it, making it appear as though they still had the coin they just spent.”<sup>39</sup> The double-spending problem is the “[h]urdle the blockchain was built to overcome.”<sup>40</sup> However, this is still all hypothetical, because the amount of computing power needed to gain 51% would be astronomical.<sup>41</sup> Without miners there would be no blockchain, with no blockchain, there would be no decentralized crypto-assets.

### A. *Bitcoin*

The need for a decentralized, peer-to-peer currency that can be transferred without the need for intermediaries is what motivated Satoshi Nakamoto to invent Bitcoin, the most popular crypto-asset today.<sup>42</sup> Who Satoshi Nakamoto is and whether he is even a real person, is still questioned to this day.<sup>43</sup> Further, there is no Bitcoin company or dedicated management group. It was this demand for anonymity while making online transactions that allowed Bitcoin to thrive.<sup>44</sup> While this is seen as a “pro” for many bitcoin users, it is perceived as a “con” to many others because Bitcoin has strengthened the online black market for illegal goods and services.<sup>45</sup> It is no secret that Bitcoin was invented in part because of the anonymity and covertness of illegal transactions.<sup>46</sup> Notwithstanding

---

<sup>35</sup> See *Amual*, *supra* note 23.

<sup>36</sup> See INVESTOPEDIA, *51% Attack*, <https://www.investopedia.com/terms/1/51-attack.asp> (last visited Oct. 3, 2018).

<sup>37</sup> See *id.*

<sup>38</sup> *Id.*

<sup>39</sup> *Id.*

<sup>40</sup> *Id.*

<sup>41</sup> See Daniel Cawrey, *Are 51% Attacks a Real Threat to Bitcoin?*, COINDESK.COM (Jun. 20, 2014), <https://www.coindesk.com/51-attacks-real-threat-bitcoin/> (explaining 51% attacks and whether they are possible based on current mining incentives and pools).

<sup>42</sup> See Grinberg, *supra* note 27, at 162 (describing the reason Bitcoin was originally invented).

<sup>43</sup> See Grinberg, *supra* note 27, at 162 (calling Satoshi Nakamoto a pseudonym).

<sup>44</sup> See Grinberg, *supra* note 27, at 162 (explaining the need for more efficient and untraceable “mediums of exchange”).

<sup>45</sup> See Middlebrook & Hughes, *supra* note 9.

<sup>46</sup> See Middlebrook & Hughes, *supra* note 9.

the abovementioned proposition, there are legal and innovative motivations for Bitcoin's creation, including the security of systems that "[c]onnect to one another over the Internet forming peer-to-peer networks, making the system a distributed one resistant to central attack."<sup>47</sup>

Bitcoin's price has exploded in the recent years as it has gained the public's interest.<sup>48</sup> By way of example, in February of 2012, its price went from about \$6 per bitcoin to over \$7,000 per coin by November of 2017.<sup>49</sup> That is estimated 116,500% growth rate in 5 years.<sup>50</sup> In other words, if one invested \$1,000 in February 2012, it would be worth \$1,165,000 in November 2017. There will only be twenty-one million Bitcoins ever released, contributing to the high-demand for them.<sup>51</sup> Many are interested in Bitcoin because of its perceived "get-rich quick" scheme especially after seeing the returns of early users.<sup>52</sup> This can be very dangerous for investors who do not understand the technology behind Bitcoin and the volatility of the crypto-asset market.

### B. *Ethereum*

Ethereum, another popular crypto-asset, "has been described as arguably the most ambitious crypto-ledger project" to date.<sup>53</sup> Like Bitcoin, Ethereum is a blockchain based crypto-asset where "miners" are compensated for providing the power, and maintaining the ledger.<sup>54</sup> While Bitcoin remains the most popular in mainstream media, many consider Ethereum to be Bitcoin's biggest threat.<sup>55</sup> Ethereum, a blockchain-based decentralized crypto-asset, is much more than a way to anonymously make transactions: "Ethereum wants to be a 'World Computer' that would

---

<sup>47</sup> See Grinberg, *supra* note 27.

<sup>48</sup> See INVESTING.COM, BTC/USD - BITCOIN US DOLLAR (2017), <https://www.investing.com/currencies/btc-usd-historical-data> (last visited Oct. 3, 2018) (showing the historical and current exchange rate for bitcoin).

<sup>49</sup> *Id.*

<sup>50</sup> *Id.*

<sup>51</sup> Kien-Meng Ly, *supra* note 13, at 590 (citations omitted).

<sup>52</sup> Michelle Singletary, *Bitcoin is all the Rage – But is it Worth the Risk?*, THE WASHINGTON POST, [https://www.washingtonpost.com/news/get-there/wp/2018/01/23/bitcoin-is-all-the-rage-but-is-it-worth-the-risk/?utm\\_term=.f71e87a35927](https://www.washingtonpost.com/news/get-there/wp/2018/01/23/bitcoin-is-all-the-rage-but-is-it-worth-the-risk/?utm_term=.f71e87a35927).

<sup>53</sup> Ari Juels & William Marino, *Understanding Smart Contract Mechanics*, JACOBS INSTITUTE, CORNELL TECH, PRACTICAL LAW FINANCE (2017).

<sup>54</sup> See Craig Eastland, *DAO Prompts SEC to Examine ICOs*, 21 No. 10 WALLSTREETLAWYER.COM: SEC. ELEC. AGE NL 3 (2017).

<sup>55</sup> Abigail Morris, *Bitcoin is the 'new EMAIL' but blockchain investor reveals why ethereum is MORE IMPORTANT*, THE EXPRESS, <https://www.express.co.uk/finance/city/901649/Bitcoin-price-ethereum-ripple-cryptocurrency-Alex-Tapscott-NextBlock-Global>.



decentralize . . . the existing client–server model.”<sup>56</sup> Ideally, Ethereum would give control back to creators and authors of all content, and not the entity that provides the software.<sup>57</sup> Many are nonetheless skeptical of this long–term goal.<sup>58</sup>

One of the reasons Ethereum is considered to be a threat to Bitcoin is because of “smart contract” technology.<sup>59</sup> Smart contracts are extremely complex. Smart contracts “[h]elp you exchange money, property, shares, or anything of value in a transparent, conflict–free way while avoiding the services of a middleman.”<sup>60</sup> Vitalik Buterin, Ethereum’s creator, explained how smart contracts work: a computer programmer creates a program that stores an asset, similar to an escrow account.<sup>61</sup> “[A]n asset or currency is transferred into a program ‘and the program runs this code and at some point it automatically validates a condition and it automatically determines whether the asset should go to one person or back to the other person, or whether it should be immediately refunded to the person who sent it or some combination thereof.’”<sup>62</sup>

A smart contract is essentially just an “If–Then premise.”<sup>63</sup> If a condition that was determined by the parties of the contract occurs, the contract is performed. As an example, imagine a seller creates a smart contract that states “I agree to trade 100 Bitcoin for 500 Ethereum, so long as the Ethereum are transferred before January 1, 2019.” The creator would put his 100 Bitcoin into a smart contract. If another party were to put 500 Ethereum into the smart contract before January 1, 2019, then the contract would automatically execute and each party would get what they were contractually obligated to receive.

However, if one party fails to fully complete the obligations under the contract, such as only 50 Ethereum are put in, and January 1, 2019 passes, the smart contract would automatically give each party back what they put in because the contract was not fulfilled. Put simply, smart contracts allow people to essentially create contracts with conditions or obligations that

---

<sup>56</sup> Alyssa Hertig, *What is Ethereum?*, COINDESK.COM, <https://www.coindesk.com/information/what-is-ethereum> (last visited Oct. 3, 2018) (explaining how Ethereum would use blockchain technology to replace the server-based model).

<sup>57</sup> See *id.* (using Google Docs as an example of an entity that has control over an author’s notes).

<sup>58</sup> See *id.* (“Although the apps appear to be possible, it’s unclear which blockchain applications will actually prove useful, secure, or scalable, and if they will ever be as convenient to use as the apps we use today.”).

<sup>59</sup> See Morris, *supra* note 55.

<sup>60</sup> *Smart Contracts: The Blockchain Technology That Will Replace Lawyers*, BLOCKGEEKS, <https://blockgeeks.com/guides/smart-contracts/>.

<sup>61</sup> See *id.*

<sup>62</sup> *Id.*

<sup>63</sup> *Id.* (using an apartment rental scenario to explain smart contracts).

must be fulfilled at a specific time defined by the contract.<sup>64</sup> These contracts will automatically execute contingent on whether those conditions are performed, without the use of any intermediaries.<sup>65</sup>

Ethereum offers other notable advantages besides smart contracts. For example, Ethereum allows for other crypto-assets to be built on top of Ethereum.<sup>66</sup> Essentially, other companies can build applications and launch their own cryptocurrencies using the Ethereum platform.<sup>67</sup> Initial Coin Offerings (“ICOs”), are “[a] fundraising technique involving the exchange of Bitcoin or Ether for specialized crypto-assets, often called ‘tokens,’” are built on the Ethereum network.<sup>68</sup> “Built” means that a company can use Ethereum’s technology to create a smart contract that issues a new crypto-asset upon receipt of payment in Ethereum. By way of example, suppose I want to raise money for ABC, my new online gambling platform. The token would give token-holders (those who buy tokens), access to ABC’s online gambling platform where they can use the tokens as payment. The smart contract created between ABC and a token-holder would state: “for every 1 Ethereum sent to this contract, I will pay out 10,000 ABC’s tokens.” The result is a crypto-asset built on top of, and utilizing, the Ethereum network. When I receive 1 Ethereum, 10,000 ABC’s will be automatically sent to the sender of the Ethereum. This process is known as an initial coin offering (“ICO”) and has resulted in the Ethereum market expanding rapidly because many people who are looking to invest in new crypto-assets through an ICO as well as companies looking to offer a new crypto-asset through ICOs, purchase Ethereum to facilitate the process.<sup>69</sup>

To summarize, Bitcoin is an exchangeable asset that acts as a store of value, much like gold or silver. While Ethereum possesses these similar traits, it adds smart-contract technology, as well as a platform that other crypto-assets can be built on top of.

---

<sup>64</sup> *Id.* (using an apartment rental scenario to explain smart contracts).

<sup>65</sup> *See id.*

<sup>66</sup> *See Eastland, supra* note 54 (“Buterin described Ethereum as a ‘Swiss-Army knife’ capable of supporting a variety of cryptocurrencies rather than just one.”).

<sup>67</sup> *Ethereum Platform - What You Should Know*, CRYPTO DIGEST NEWS, <https://cryptodigestnews.com/ethereum-platform-what-you-should-know-900ff0b5b5ec>.

<sup>68</sup> *See Eastland, supra* note 54.

<sup>69</sup> *See Steven McKie, Understanding the Ethereum ICO Token Hype*, BLOCKCHANNEL, <https://medium.com/blockchannel/understanding-the-ethereum-ico-token-hype-429481278f45> (describing the ICO process on the Ethereum network).

### III. ALONG CAME HOWEY

*SEC v. Howey* is the case that lays out whether a transaction constitutes an investment contract.<sup>70</sup> W.J. Howey Company (“Howey Co.”) planted about 500 acres of citrus land in Lake County, Florida.<sup>71</sup> Howey offered half of the land for purchase by the public “[t]o help . . . finance additional development.”<sup>72</sup> Howey-in-the-Hills Service, Inc. (“Howey Service”), is a company that cultivated, developed, harvested and marketed many of the crops.<sup>73</sup> Though potential purchasers may have contracted with any service company, they were “[t]old that it is not feasible to invest in a grove unless service arrangements are made,” and were offered a service contract, in addition to their land sales contract with Howey Service.<sup>74</sup> While the Howey Co. land sales contract granted the purchaser the land by warranty deed “[u]pon full payment of the purchase price,” the Howey Service contract “[g]ave Howey Service a leasehold interest and ‘full and complete’ possession of the acreage.”<sup>75</sup> Further, “[t]he company [was] given full discretion and authority over the cultivation of the groves and the harvest and marketing of the crops.”<sup>76</sup> The majority of purchasers were businessmen that worked in a hotel owned by Howey Co., who did not possess the skill or equipment required to manage a citrus farm, but were nonetheless “[a]ttracted by the expectation of substantial profits.”<sup>77</sup>

The majority opinion, written by Justice Murphy, reversed the ruling by the Fifth Circuit, and held that the transactions of land were investment contracts.<sup>78</sup> The main issue before the Supreme Court was whether “[t]he land sales contract, the warrant deed and the service contract together constitute an investment contract within the meaning of” Section 2(1) of the Securities Act of 1933.<sup>79</sup> Justice Murphy noted that if the answer was

---

<sup>70</sup> SEC v. W.J. Howey Co., 328 U.S. 293, 297 (1946).

<sup>71</sup> *Id.* at 295.

<sup>72</sup> *Id.* (quoting Howey’s reason for offering half the land to the public) (internal quotations omitted).

<sup>73</sup> *Id.*

<sup>74</sup> *Id.* (“85% of the acreage sold during the 3-year period ending May 31, 1943, was covered by service contracts with Howey-in-the-Hills Service, Inc.”).

<sup>75</sup> *Id.* at 295-96 (quoting the language of the service contract).

<sup>76</sup> *Id.* at 296.

<sup>77</sup> Howey, 328 U.S. at 296.

<sup>78</sup> *Id.* at 301 (rejecting the suggestion by the Fifth Circuit Court of Appeals that “[A]n investment contract is necessarily missing where the enterprise is not speculative . . . and where the tangible interest which is sold has intrinsic value independent of the success of the enterprise as a whole.”) (citations omitted).

<sup>79</sup> *Id.* at 297 n.3 (citing Section 2(1) of the Securities Act of 1933, that defines the term security) (“The term ‘security’ means any note, stock, treasury stock, security future, security-based swap, bond, debenture, evidence of indebtedness, certificate of interest or

yes, “[t]he registration requirements of Section 5(a)” of the Act of 1933 would apply to the transaction.<sup>80</sup>

The Court laid out a two-factor test to determine whether a transaction is an investment contract: (1) whether the scheme involves an investment of money in a common enterprise; and (2) whether the profits of such investment come solely from the efforts of others.<sup>81</sup> The Court determined that, without analyzing the two factors separately, the transaction was an investment contract because Howey Co. was “[o]ffering an opportunity to contribute money and to share in the profits of a large citrus fruit enterprise managed and partly owned by respondent.”<sup>82</sup> Moreover, the Court found the investors were “[a]ttracted solely by the prospects of a return on their investment.”<sup>83</sup> The Court was persuaded by the fact that some purchasers chose not to accept rendering the Howey Service contract irrelevant because “[t]he Securities Act prohibits the offer . . . of unregistered non-exempt securities.”<sup>84</sup> Ultimately, the *Howey* Court made clear that a transaction is still an investment contract even if there is no speculation in an investment because of some “[i]ntrinsic value independent of the success of the enterprise as a whole.”<sup>85</sup>

#### IV. UNDERSTANDING THE *HOWEY* TEST

##### A. *Investment of Money in a Common Enterprise*

###### a. Interpretations

The *Howey* Test has withstood the test of time and is still relevant law to this day.<sup>86</sup> In *SEC v. Edwards*, the Court examined whether a scheme

---

participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a ‘security’, or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.”); 15 U.S.C. § 77.

<sup>80</sup> *Id.* at 297.

<sup>81</sup> *Id.* (quotations omitted).

<sup>82</sup> *Id.* at 299.

<sup>83</sup> *Howey*, 328 U.S. at 300.

<sup>84</sup> *Id.* at 300-01 (quotations omitted).

<sup>85</sup> *Id.* at 301.

<sup>86</sup> *See SEC v. Edwards*, 540 U.S. 389, 393 (2004) (upholding the *Howey* Test).

that “[o]ffered a contractual entitlement to a fixed, rather than variable, return” could still be considered an investment contract.<sup>87</sup> The Court, applying *Howey*, found that the promise of a fixed return could still be an investment contract subject to securities laws because “[t]here is no reason to distinguish between promises of fixed returns and promises of variable returns for purposes of the test.”<sup>88</sup> However, the scope of investments has been expanded since *Howey* was decided.<sup>89</sup> In *Reves v. Ernst & Young*, the Court stated that the form an investment takes is irrelevant because “Congress’ purpose in enacting the securities laws was to regulate *investments*, in whatever form they are made and by whatever name they are called.”<sup>90</sup> In *Reves*, the Farmers’ Cooperative of Arkansas and Oklahoma (“Co-Op”) “sold promissory notes payable on demand by the holder,” “marketing the scheme as an ‘Investment Program.’”<sup>91</sup> The Court determined the notes were securities because the purpose of “[t]he Securities Acts is ‘to eliminate serious abuses in a largely unregulated securities market.’”<sup>92</sup> Further, an investment of money has been made if “[a]n investor chose to give up a specific consideration in return for a separable financial interest with the characteristics of a security.”<sup>93</sup> By stating “specific consideration” instead of money or cash, the meaning of money in *Howey* is expanded to other assets.<sup>94</sup>

The next, and more debated topic in this element is the investment made in a common enterprise. Circuits are split on how to determine whether an investment is made in a common enterprise.<sup>95</sup> Some circuits use horizontal commonality, and some use vertical commonality.<sup>96</sup>

Horizontal commonality is “[t]he tying of each individual investor’s fortunes to the fortunes of the other investors by the pooling of assets, usually combined with the pro-rata distribution of profits.”<sup>97</sup> Thus, in a horizontal enterprise, the success of the investment depends “[u]pon the profitability of the enterprise as a whole.”<sup>98</sup> In *SEC v. SG Ltd.*, the First Circuit held that “[t]he pooling of assets from multiple investors in such a manner that all share in the profits and risks of the enterprise” satisfies

---

<sup>87</sup> *Id.* at 391.

<sup>88</sup> *Id.* at 394.

<sup>89</sup> *See Reves v. Ernst & Young*, 494 U.S. 56, 61 (1990) (quotations omitted).

<sup>90</sup> *Id.* at 61 (emphasis in original).

<sup>91</sup> *Id.* at 58-59.

<sup>92</sup> *Id.* at 60 (citing *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837, 849 (1975)).

<sup>93</sup> *Int’l Bhd. of Teamsters v. Daniel*, 439 U.S. 551, 559 (1979).

<sup>94</sup> *See id.* at 559.

<sup>95</sup> *See Revak v. SEC Realty Corp.*, 18 F. 3d 81, 87-89 (2d Cir. 1994).

<sup>96</sup> *See id.*

<sup>97</sup> *Id.* at 87.

<sup>98</sup> *Id.*; *Hart v. Pulte Homes of Mich. Corp.*, 735 F. 2d 1001, 1004 (6th Cir. 1984).

horizontal commonality.<sup>99</sup> The court goes on to say that pooling alone is not enough, but “[t]hat investors share in the profits and the risk of the enterprise.”<sup>100</sup> In that case, the investors’ money was accumulated into a single account by way of “pooling.”<sup>101</sup> Further, the fact that the investment was a pyramid scheme that required continuous investments inherently ties together the risk of profits and losses for investors.<sup>102</sup> Finally, the company offering the investment promised a return simply for contributing money to the pool.<sup>103</sup> All of these facts taken together led the First Circuit to conclude that these investments satisfied horizontal commonality, and therefore the common enterprise prong.<sup>104</sup>

Conversely, in *Deckebach v. La Vida Charters, Inc. of Florida*, the Sixth Circuit found that “a finding of horizontal commonality requires more than the facts of this case demonstrate.”<sup>105</sup> There, the plaintiff, Deckebach, purchased a yacht for chartering from defendant, La Vida, a yacht management company, by trading in their old yacht as down payment.<sup>106</sup> Deckebach agreed “[t]o purchase the yacht for \$120,500, contingent upon agreeing to contract with La Vida to manage the yacht.”<sup>107</sup> It is important to note that Deckebach never placed money in a common fund or pooling of funds with other owners and the income generated by charters of each yacht.<sup>108</sup> “The Deckebach’s yacht never operated at a profit,” and now they “contend that the purchase/management agreement” satisfies the *Howey* Test.<sup>109</sup> However, as stated above, the Sixth Circuit held that there was no horizontal commonality here because “[t]he financial success of the individual yacht owners was independent of the financial success of La Vida.”<sup>110</sup>

Further, La Vida received a monthly fee from the yacht owners, and “[t]he success of the La Vida enterprise and its ability to attract charters had only an indirect impact upon the individuals contracting with La Vida.”<sup>111</sup> Deckebach argued that La Vida made a uniform effort to allocate

---

<sup>99</sup> SEC v. SG Ltd., 265 F. 3d 42, 50 (1st Cir. 2001).

<sup>100</sup> *Id.* at 50.

<sup>101</sup> *Id.*

<sup>102</sup> See *id.* at 51 (citing SEC v. Infinity Group Co., 212 F. 3d 180, 184-85 (finding horizontal commonality where investors invested their money into a pool and were given returns on a pro rata basis of their investment)).

<sup>103</sup> See *id.* at 44.

<sup>104</sup> *Id.* at 50.

<sup>105</sup> *Deckebach v. La Vida Charters, Inc. Fla.*, 867 F. 2d 278, 283 (6th Cir. 1989).

<sup>106</sup> See *id.* at 279-80.

<sup>107</sup> *Id.* at 280.

<sup>108</sup> *Id.* (quotations omitted) (alterations added).

<sup>109</sup> *Id.* at 280-81.

<sup>110</sup> *Deckebach*, 867 F.2d at 283.

<sup>111</sup> *Id.*

income among various yacht owners by a sequential course of chartering, proving horizontal commonality.<sup>112</sup> However, there was no pooling of funds and certain expenses were divided on a pro rata basis.<sup>113</sup> Therefore, the Sixth Circuit affirmed the District Court's decision stating that there was not enough here to constitute horizontal commonality.<sup>114</sup> Today, horizontal commonality is accepted by the majority of Circuits.<sup>115</sup>

Vertical commonality "[f]ocuses on the relationship between the promoter and the body of investors."<sup>116</sup> Under vertical commonality, "[t]he critical factor is not the similitude or coincidence of investor input, but rather the uniformity of impact of the promoter's efforts."<sup>117</sup> In other words, it is the promoter's efforts impacting the investors as a whole that is most important.<sup>118</sup> In *SEC v. Koscot*, potential investors are lured to meetings where they are sold the idea that if they invest a substantial amount of money, they will receive discounts on cosmetic supplies that they can sell for a large profit.<sup>119</sup> If a previous investor referred someone to a meeting, and that person invests, the referrer receives a portion of money.<sup>120</sup> However, once the potential investor is lured to the meeting, it is up to Koscot to sell them on investing, not the referrer (a standard pyramid scheme).<sup>121</sup>

The Fifth Circuit found that the common enterprise element was met through vertical commonality because "[t]he fortunes of all investors [were] inextricably tied to the efficacy of the Koscot meetings."<sup>122</sup> In coming to this conclusion the Fifth Circuit rejected the standard of horizontal commonality some Circuits require by stating that *Howey* did not emphasize whether the profits were pooled, but instead "[t]hat the feasibility and success of the enterprise . . . rested on the availability of

---

<sup>112</sup> *Id.* at 282 (quotations omitted).

<sup>113</sup> *Id.*

<sup>114</sup> *Id.* at 283.

<sup>115</sup> *See, e.g., SEC v. Life Partners, Inc.*, 87 F. 3d 536, 543 (D.C. Cir. 1996);

*SEC v. SG Ltd.*, 265 F. 3d 42, 50 (1st Cir. 2001);

*Revak v. SEC Realty Corp.*, 18 F. 3d 81, 87 (2d Cir. 1994);

*Revak v. SEC Realty Corp.*, 18 F. 3d 81, 87 (2d Cir. 1994); *Salcer v. Merrill Lynch*, 682

F. 2d 459, 460 (3d Cir. 1982); *Hart v. Pulte Homes of Mich. Corp.*, 735 F. 2d 1001, 1004

(6th Cir. 1984); *Milnarik v. M-S Commodities, Inc.*, 457 F. 2d 274, 276 (7th Cir. 1972).

<sup>116</sup> *Revak*, 18 F. 3d at 87 (citations omitted).

<sup>117</sup> *SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473, 478 (5th Cir. 1974).

<sup>118</sup> *Id.* at 478.

<sup>119</sup> *See id.* at 475.

<sup>120</sup> *See id.*

<sup>121</sup> *See id.*

<sup>122</sup> *Id.* at 479.

the Howey Company's management."<sup>123</sup> The Fifth, Ninth, and Eleventh Circuits currently require vertical commonality in some form.<sup>124</sup>

To complicate things further, Circuits that adopted vertical commonality have since split into two separate regimes: broad and narrow vertical commonality.<sup>125</sup> Narrow commonality circuits require "a direct correlation between the promoter's success or failure and the investors' profits or losses."<sup>126</sup> For example, under narrow commonality, "there is no common enterprise if . . . the promoter receives a flat commission irrespective of whether the investor makes or loses money on the underlying venture."<sup>127</sup> However, broad commonality only requires an "interdependence between the investors and the promoter" that can be shown "by the investors' collective reliance on the promoter's expertise even where the promoter receives only a flat fee or commission rather than a share in the profits of the venture."<sup>128</sup> For this reason, broad commonality is generally the easier of the commonalities to satisfy. The Fifth and Eleventh Circuits use broad commonality, while the Ninth Circuit uses narrow.<sup>129</sup>

## b. Analysis

Many consider buying Bitcoin or Ethereum an investment of money. However, there are many reasons one would buy Bitcoin or Ethereum not as an investment; the common one being to transact anonymously. Therefore, if it is determined that the purchase of Bitcoin or Ethereum was not intended to be an investment, then this factor cannot be satisfied. Assuming *arguendo*, that the purchase is an investment, the question becomes whether this is an investment in a common enterprise. As stated earlier, there are three different ways that courts can determine this element: (1) horizontal commonality; (2) broad vertical commonality; and (3) narrow vertical commonality.<sup>130</sup>

Under horizontal commonality, it is very tight whether Bitcoin and Ethereum satisfy the common enterprise factor.<sup>131</sup> When buying Bitcoin or Ethereum, most people go through an exchange in order to purchase it.

---

<sup>123</sup> Koscot Interplanetary, 497 F.2d at 478 (citing Howey, 328 U.S. at 300).

<sup>124</sup> See Long v. Shultz Cattle Co., 881 F.2d 129, 140 (5th Cir. 1989); Villeneuve v. Advanced Bus. Concepts Corp., 698 F.2d 1121, 1124 (11th Cir.1983); Glenn W. Turner Enters., Inc., 474 F.2d 476, 482 (9th Cir.1973).

<sup>125</sup> See Long, 881 F.2d at 140-41.

<sup>126</sup> *Id.* at 140.

<sup>127</sup> *Id.* (citing Brodt v. Bache & Co., 595 F.2d 459, 461 (9th Cir.1978)).

<sup>128</sup> *Id.* at 141.

<sup>129</sup> See *id.* at 140-41.

<sup>130</sup> See Revak, 18 F.3d at 87; Long, 881 F.2d at 140-41.

<sup>131</sup> See Revak, 18 F.3d at 87 (defining horizontal commonality).



Unlike a share of common stock where a company issues shares, people pay for them, and the proceeds go to the company, there is no Bitcoin company. The money spent on Bitcoin does not go to one single entity because one does not exist. Therefore, because the proceeds of the sold Bitcoin do not go to one entity, there is no pooling of funds. It is important to remember that pooling is not the only factor in horizontal commonality.<sup>132</sup> The “[i]nvestors [must] share in the profits and the risk of the enterprise.”<sup>133</sup> It is hard to argue against the fact that investors share the risk of buying Bitcoin and Ethereum. Bitcoin holders want the price of Bitcoin to rise, resulting in profits. Similarly, when the price falls, investors share risk. It would appear that the investors do share in both the profits and losses of Bitcoin together even if there is no pooling of funds.

Similar to the court’s finding in *Deckebach*, it does not appear that there is enough to constitute a finding of horizontal commonality.<sup>134</sup> Just as there was no pooling in *Deckebach*, there is no pooling of funds with Bitcoin and Ethereum.<sup>135</sup> Further, the financial success of the yacht owners was independent of the success of La Vida, and its financial success only had an indirect impact upon the individuals. The same applies to Bitcoin and Ethereum. An exchange having success only has an indirect impact on a purchaser’s success by causing the market to rise and is independent of the success of the promoter.<sup>136</sup> Therefore, horizontal commonality is a close call, but it appears Bitcoin and Ethereum may be considered a common enterprise if the court focuses on the fact that all investors “[s]hare in the profits and the risk of the enterprise.”<sup>137</sup> However, when focusing on the pooling of funds and the direct impact on the success of the investment, it is unlikely to be considered a common enterprise.<sup>138</sup>

Narrow vertical commonality is satisfied when there is “[a] direct correlation between the promoter’s success or failure and the investors’ profits or losses.”<sup>139</sup> It is likely that neither Bitcoin or Ethereum satisfy narrow commonality. The reason they do not satisfy the factor comes from an example given above: “[t]here is no common enterprise if . . . the promoter receives a flat commission irrespective of whether the investor makes or loses money on the underlying venture.”<sup>140</sup> This is precisely what

---

<sup>132</sup> See *SG Ltd.*, 265 F.3d at 50 (stating that the pooling of funds is not the only factor in the horizontal commonality analysis).

<sup>133</sup> *Id.*

<sup>134</sup> See 867 F.2d at 283.

<sup>135</sup> See *id.* at 280.

<sup>136</sup> See *id.* at 282-83.

<sup>137</sup> *SG Ltd.*, 265 F.3d at 50.

<sup>138</sup> See *Deckebach*, 867 F.2d at 280-83.

<sup>139</sup> *Long*, 881 F.2d at 140.

<sup>140</sup> *Id.* (citing as an example, *Brodt v. Bache & Co.*, 595 F.2d 459, 461 (9th Cir.1978)).

happens when an investor purchases Bitcoin or Ethereum through an exchange. Coinbase, an exchange for the crypto-assets, takes a flat fee upon purchase of the Bitcoin or Ethereum, and whether your Bitcoin goes up or down in value has no bearing on the fee or return Coinbase makes.<sup>141</sup> There is an argument to be made that Coinbase does have a vested interest in you making money on your investment because then you are more likely to continue using their exchange; however, a third-parties success, with no actual monetary interest, is a weak argument to consider Coinbase having a vested interest in every dollar its users spend on other companies. Therefore, it is likely that neither Bitcoin nor Ethereum satisfies the narrow commonality test.

Finally, broad vertical commonality is satisfied when the investors, together, rely upon the promoter for their expertise or managerial efforts.<sup>142</sup> The key here is the collectiveness of the reliance on the managerial efforts or expertise.<sup>143</sup> Not all investors rely on managerial efforts. It is possible for one to mine, or purchase, and control their own Bitcoin or Ethereum without any expertise or managerial efforts from a third-party. In fact, there is no managerial efforts when it comes to Bitcoin because there is no controlling entity, or management group. Ethereum differs slightly because there is a development team that builds the foundation of Ethereum; however, there is still no controlling entity, just each individual's own stash of Ethereum.<sup>144</sup> Therefore, because it is possible to have no reliance on a promoter or third-party, it is likely that broad commonality is not satisfied by Bitcoin or Ethereum.

In summation, it is possible that Bitcoin and Ethereum both satisfy the common enterprise factor if the court is applying horizontal commonality. However, there is a fairly strong argument that the purchase of Bitcoin or Ethereum is not an investment in the first place. Further, if the court finds the purchase to be an investment and applies either narrow or broad vertical commonality, it is less likely that either will be considered an investment in a common enterprise. It is important to remember that even if considered an investment in a common enterprise, it does not mean that the *Howey* Test is satisfied as this is just one factor.

---

<sup>141</sup> *Coinbase Fees*, [https://support.coinbase.com/customer/en/portal/articles/1826294-how-are-fees-applied-when-i-buy-or-sell-digital-currency?b\\_id=13521](https://support.coinbase.com/customer/en/portal/articles/1826294-how-are-fees-applied-when-i-buy-or-sell-digital-currency?b_id=13521).

<sup>142</sup> *Id.* at 141.

<sup>143</sup> *See id.* (stating that the “investors’ collective reliance on the promoter’s expertise” is when broad commonality is satisfied).

<sup>144</sup> *See Hertig, supra* note 56.

*B. Profits Solely from the Efforts of Others*

*a. Interpretations*

The *Howey* Test states that to be an investment contract profits must “[c]ome solely from the efforts of others.”<sup>145</sup> This originally meant that any effort from the investors means there is no investment contract, and this factor was not satisfied.<sup>146</sup> However, the term solely has been dropped and has been replaced with a requirement “[t]hat the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise.”<sup>147</sup> The main reason for dropping solely was due to the “policy of affording broad protection to the public, and the Supreme Court’s admonitions that the definition of securities should be a flexible one.”<sup>148</sup> In *SEC v. Glenn W. Turner Enterprises, Inc.*, investors paid money to Dare, a subsidiary of the defendant, in exchange for sales trainings and meetings, but more importantly, the ability to bring others to meetings and have Dare sell them the same trainings and meetings—a standard pyramid scheme.<sup>149</sup> The original investor was promised a portion of all sales Dare makes from people brought in by the original investor.<sup>150</sup> The Ninth Circuit found that the profits from a promoter prong of *Howey* was satisfied even though the investor had to put in some effort, in the form of appearing wealthy and bringing others to meetings because the return on their investment still falls on the sales ability of Dare.<sup>151</sup>

More recently, the SEC has begun investigating more and more crypto-assets, especially tokens being offered through an ICO.<sup>152</sup> Protostarr was “[a] way for rising internet celebrities on YouTube, Twitch and other video and live streaming platforms to get funded by their fans.”<sup>153</sup> Investors would buy a decentralized token offered through an

---

<sup>145</sup> *Howey*, 328 U.S. at 301.

<sup>146</sup> See *SEC v. Glenn W. Turner Enter., Inc.*, 474 F.2d 476, 482-83 (9th Cir. 1973).

<sup>147</sup> *Hocking v. Dubois*, 885 F.2d 1449, 1455 (9th Cir. 1989) (quoting *Glenn W. Turner Enters.*, 474 F.2d at 482) (finding that for policy purposes the term solely should be dropped from the requirement) (internal quotations omitted).

<sup>148</sup> *Glenn W. Turner Enters.*, 474 F.2d at 482.

<sup>149</sup> *Id.* 478-79.

<sup>150</sup> *Id.* at 482.

<sup>151</sup> *Id.*

<sup>152</sup> See BLOCKSHARKS, *Death of Protostarr ICO: legal review by BlockSharks*, MEDIUM.COM (Sept. 10, 2017), <https://medium.com/@blocksharks/death-of-protostarr-ico-legal-review-by-blocksharks-d0799dbc2f79>.

<sup>153</sup> Laura Shin, *After Contact By SEC, Protostarr Token Shuts Down Post-ICO, Will Refund Inv’rs*, FORBES.COM (Sept. 1, 2017), <https://www.forbes.com/sites/laurashin/2017/09/01/after-contact-by-sec-protostarr-token-shuts-down-post-ico-will-refund-investors/#40d2c84192ec>.

ICO, and Protostarr would invest the money in upcoming internet celebrities, thus raising the price of the token.<sup>154</sup> After a phone call from the SEC, Protostarr shut down operations and refunded investors.<sup>155</sup> It is likely that the SEC was going to find that Protostarr's token was a security. The coin was an investment of money by investors, pooled together in Protostarr's accounts, and then invested in content creators that Protostarr chose.<sup>156</sup> Essentially, the investors invested their money and sat back and watched their investment grow. This is about the plainest case of a security one will see and is not surprising that the SEC made them refund their investors.

Another example of the SEC stepping in on a crypto-asset is Slock.it, whose crypto-asset was deemed a security.<sup>157</sup> The company, Slock.it, allowed investors to purchase tokens which granted tokenholders the ability to vote on different projects which would then be funded through the investors' money.<sup>158</sup> This is more commonly known as a DAO ("Decentralized Autonomous Organization") Token.<sup>159</sup> It may appear at first glance that this token should not satisfy the final factor of *Howey*, namely, the efforts of a third party, because the investors are voting on and choosing what projects to fund.<sup>160</sup> However, "[t]he SEC noted that the DAO token holders did indeed have the right to propose projects and vote on which projects would receive funding, but that the curators held ultimate discretion in choosing which projects would be voted upon."<sup>161</sup> In short, the token holders were given the illusion of control and influence; however final say still rested with management.<sup>162</sup> This is a less sure-fire security than Protostarr because the tokenholders did have some influence on decisions made, but is an example of how even the appearance of influence by tokenholders may be insufficient to the SEC's application of *Howey*.

---

<sup>154</sup> See *id.*

<sup>155</sup> See BLOCKSHARKS, *supra* note 152.

<sup>156</sup> See BLOCKSHARKS, *supra* note 152.

<sup>157</sup> See Tracy L. Hooey, Daniel Fuke and Simar Anand, *SEC Concludes that Slock.It's DAO Dig. Currency Tokens are Sec.*, TIMELYDISCLOSURE.COM (July 28, 2017), <https://www.timelydisclosure.com/2017/07/28/sec-concludes-that-slock-its-dao-digital-currency-tokens-are-securities/>.

<sup>158</sup> See David Siegel, *Understanding the DAO Attack*, COINDESK.COM (June 25, 2016) <https://www.coindesk.com/understanding-dao-hack-journalists/>.

<sup>159</sup> See *id.*

<sup>160</sup> See generally Hocking, 885 F.2d at 1455.

<sup>161</sup> Hooey, *supra* note 157.

<sup>162</sup> See Hooey, *supra* note 157.

## b. Analysis

The final factor in the *Howey* Test analysis is whether the profits came from the efforts of others.<sup>163</sup> It is important to remember that “solely” has been dropped in subsequent cases.<sup>164</sup> Both Bitcoin and Ethereum are unlikely to satisfy this final factor because it is possible to receive profits without any outside influence or managerial efforts.<sup>165</sup> Once Bitcoin is purchased from a seller that seller no longer has an influence on the buyers Bitcoin. The counter–argument is that without the efforts of other miners and exchanges Bitcoin and Ethereum would not rise in value. However, this is not convincing because market fluctuation is different than the seller of a crypto–asset having a direct influence on the success of your investment. Further, it is easy to think of an example where one would pay a premium for Bitcoin because of the complexity of buying or mining it. Bitcoin, as stated earlier, serves mostly as a store of value, and an exchangeable crypto–asset. There is no management team or single company that controls Bitcoin, thus making the argument that there are efforts coming from the promoter or third party very difficult.<sup>166</sup> However, purchasing Bitcoin or Ethereum and just waiting for the price to rise, similar to the stock of a corporation, seems compelling that the profits came from the efforts of others.<sup>167</sup>

One important distinction between Bitcoin and Ethereum, is the Ethereum platform. Other companies may build on top of the Ethereum platform and create their own crypto–assets.<sup>168</sup> This seems to be the plainest example of taking the influence away from the promoter of Ethereum. Imagine a person buys Ethereum, creates his own app on top the Ethereum platform, and as a result the price of Ethereum rises. This seems to be a very convincing argument that Ethereum does not satisfy this factor of *Howey*. Therefore, it is more likely than not that Bitcoin does not satisfy this factor. Further, it seems even more convincing that Ethereum does not satisfy this factor either because of the ability to build on top of the Ethereum platform.

---

<sup>163</sup> See *Howey*, 328 U.S. at 297.

<sup>164</sup> See Glenn W. Turner Enters., 474 F.2d at 481-82; *Hocking*, 885 F.2d at 1455.

<sup>165</sup> See Andrew Norry, *How to Make Money with Bitcoin: 10 Ways to Earn Cryptocurrency*, BLOCKONOMI.COM, <https://blockonomi.com/how-to-make-money-bitcoin/>.

<sup>166</sup> See BLOCKGEEKS, *What is Bitcoin? The Most Comprehensive Guide Ever!*, BLOCKGEEKS.COM, <https://blockgeeks.com/guides/what-is-bitcoin/> (explaining “[b]itcoin has no central monetary authority”).

<sup>167</sup> See *Howey*, 328 U.S. at 297 (explaining the profits coming from the efforts of others factor).

<sup>168</sup> See Eastland, *supra* note 54.

## V. CONCLUSION

In conclusion, while there is a lot of confusion and controversy over crypto-assets right now, especially with the SEC lurking closely in the background, it is unlikely that two of the more popular crypto-assets qualify as investment contracts under the *Howey* Test. There are convincing arguments to be made for both factors, but it seems slightly more likely than not that neither satisfies the test. Bitcoin and Ethereum are unlikely to satisfy the common enterprise element because the purchase may not be an investment, and there is no reliance on a third-party or promoter. However, if the case is in a circuit that uses horizontal commonality there is a chance that both Bitcoin and Ethereum do satisfy this factor because the investors' money is directly tied together with the risk and profits of the enterprise as a whole.<sup>169</sup> In addition, it is unlikely that Bitcoin and Ethereum satisfy the factor requiring profits to come from the efforts of others because of the ability to mine, control, and sell one's own coins without the efforts from others to raise the price of your crypto-assets.

It is important to remember that policy factors weigh heavily in this situation. There are two policy factors in particular here that seem to oppose each other. First, is the protection of investors from fraudulent or risky investments. Second, is the innovation of technology for the improvement of society.

Investor Protection has been at the forefront of public policy for many years. During the Great Depression, President Franklin D. Roosevelt signed the Securities Acts of 1933 and 1934 into law.<sup>170</sup> Then in 2010, President Barack Obama signed the Dodd Frank Act and the Consumer Protection Act into law following the 2008 market crash.<sup>171</sup> This shows that investor protection is heavily valued, especially after a major market downturn. However, with investor protection comes some inherent "side-effects." Many of those are good side-effects but are something to think about none the less. The Securities Laws put into place make it very expensive for a company to become publicly traded due to the registration and disclosure requirements.<sup>172</sup> It is important to note that many of these

---

<sup>169</sup> See Revak, 18 F.3d at 87 (defining horizontal commonality).

<sup>170</sup> See *Securities Act of 1933*, INVESTOPEDIA.COM, <https://www.investopedia.com/terms/s/securitiesact1933.asp> (last updated 2018); see also, *Securities Act of 1934*, INVESTOPEDIA.COM, <https://www.investopedia.com/terms/s/seact1934.asp> (last updated 2018).

<sup>171</sup> See *Dodd-Frank Wall Street Reform and Consumer Protection Act*, INVESTOPEDIA.COM, <https://www.investopedia.com/terms/d/dodd-frank-financial-regulatory-reform-bill.asp> (last updated 2018).

<sup>172</sup> See *Considering an IPO to fuel your company's future?*, PWC.COM (Nov. 2017), <https://www.pwc.com/us/en/deals/publications/cost-of-an-ipo.html> (stating that CFO's of

laws are crucial in ensuring that companies listed on stock exchanges are not defrauding investors out of their money. However, these costs also limit the availability of many companies to even be listed publicly because less companies can afford to be traded publicly. If the United States Government passes laws that require similar disclosure and registration, or enacts a new law requiring similar documentation, then it is nearly certain that we will see less companies offering crypto-assets in the future.

On the other hand, after seeing what happened when the dotcom bubble burst, many believe that crypto is a bubble that will pop as well, resulting in millions of dollars in losses.<sup>173</sup> The question is, is the bubble bursting a bad thing? Look at what happened when the internet bubble burst: it “brought us a cheap worldwide fiber backbone and companies like Amazon and Google.”<sup>174</sup> “A bubble brings attention and investment in infrastructure, which breeds real innovation.”<sup>175</sup> But at what costs? As of right now, most crypto-assets and exchanges offering crypto-assets are functioning under the mantra “buyer beware.”<sup>176</sup> As a result there have been fraudulent ICOs where people purchased coins with their money, and the company took the money and ran, leaving the purchasers with little to no remedy for their lost crypto-assets.<sup>177</sup> The lack of regulation in the crypto space has it feeling like the wild-west. However, many believe this is a good thing because it allows startups to have access to more capital at lower costs than would be generally available through the traditional Venture Capital money raising rounds.<sup>178</sup>

This leaves the Legislation and the Supreme Court with difficult decisions. Do we want to promote innovation by allowing startups to have

---

public companies spend “[b]etween \$1 million and \$1.9 million annually on the costs of being public”).

<sup>173</sup> See Ben Geier, *What Did We Learn From the Dotcom Stock Bubble of 2000?*, TIME.COM (Mar. 12, 2015), <http://time.com/3741681/2000-dotcom-stock-bust/>; see also Jon Evans, *The cryptocurrency bubble is strangling innovation*, TECHCRUNCH.COM (Jan. 7, 2018), <https://techcrunch.com/2018/01/07/the-cryptocurrency-bubble-is-strangling-innovation/>.

<sup>174</sup> Evans, *supra* note 173.

<sup>175</sup> Evans, *supra* note 173.

<sup>176</sup> See Alex Hern, *Bitcoin buyer beware: US SEC warns ‘extreme caution’ over cryptocurrency investments*, THEGUARDIAN.COM (Dec. 12, 2017), <https://www.theguardian.com/technology/2017/dec/12/bitcoin-buyer-beware-us-sec-warns-extreme-caution-over-cryptocurrency-investments>.

<sup>177</sup> See Stan Higgins, *SEC Files Fraud Charges Against ICO Organizer*, COINDESK.COM (Dec. 4, 2017), <https://www.coindesk.com/sec-files-fraud-charges-canadian-ico-organizer/>.

<sup>178</sup> See Jia Wertz, *Are ICOs The New Startup Life Blood?*, FORBES.COM (Dec. 2, 2017, 04:20 PM), <https://www.forbes.com/sites/jiawertz/2017/12/02/icos-new-startup-lifeblood/#76b28f58525b> (explaining how ICOs give startups greater access to capital as compared to funding through Venture Capitalists).

access to more capital, resulting in more innovative, disruptive companies, but at the expense of risk to the average investor? Or do we want to protect investors from fraudulent or highly risky investments at the expense of innovating and expanding society? The correct answer is likely somewhere in the middle of those two, but it will be fascinating to see how that issue is addressed, if at all.

This leads to the question, why do we care? Other than the strict disclosure requirements of the Securities Acts discussed above, declaring crypto-assets as securities could impact holders of the assets, and the crypto market as a whole. The tax implications to holders could be significant if the classification as a security changes when or how the assets must be reported on one's income tax filing. This would likely result in fewer options for holders due to the high costs of complying with the Securities Acts when issuing securities to the public.<sup>179</sup> With fewer options comes less innovation, and the whole crypto market may suffer from a technological standpoint because of the difficulty for companies to raise funds in more traditional ways.<sup>180</sup>

The heavy uncertainty around crypto-assets seems to suggest we are heading towards some sort of clarity. Whether that clarity is either legislation or a Supreme Court decision remains to be seen. Crypto-assets are hard to understand for many right now, not only for their technical complexity, but also because they do not fit neatly into any one category because we have never dealt with anything like them before. Government and courts will have to make other important decisions such as, for example, deciding whether crypto-assets are commodities, securities, property, currencies, or something else entirely. These decisions would all have major implications on the future regulation of crypto-assets just like being termed an investment contract would. When a court is faced with a policy heavy situation or an entirely unique situation, it may construct a new rule or find a way to make the new situation fit in the way which is best for society as a whole regardless of whether it is a clean fit or not. The Supreme Court will eventually face a crypto-assets case, and it is possible that they will construct a new rule to provide some sort of clarity on the situation. It is also entirely possible the Court will defer to the Legislative Branch.

Legislation may be enacted on how to regulate, or control crypto-assets, or even just what to classify them as. There is also the question of what a regulation of crypto-assets would even look like. Due to the

---

<sup>179</sup> See Jay Ritter, *Why Is Going Public So Costly?*, FORBES.COM (Jun. 19, 2014, 04:29 PM), <https://www.forbes.com/sites/jayritter/2014/06/19/why-is-going-public-so-costly/#14a220e4ff0a>.

<sup>180</sup> See Wertz, *supra* note 178.



decentralization and anonymity that is at the heart of crypto-assets, it seems to be an incredibly difficult challenge to regulate it. It could mean taxation requirements when the crypto-asset is transferred in any form, including from crypto-asset to crypto-asset.<sup>181</sup> It could also mean registration and disclosure requirements, similar to publicly traded companies, as laid out in the Securities Acts of 1933 and 1934.

Finally, it appears that Bitcoin and Ethereum do not satisfy the *Howey* Test, meaning they are not considered investment contracts, and therefore not responsible for the registration and disclosure requirements of securities laws. Bitcoin and Ethereum are unlikely to be considered “an investment of money in a common enterprise” because the money is not pooled together, the promoter receives a flat fee, and the success is not directly tied to managerial expertise.<sup>182</sup> The only possibility of satisfying this prong is if the court applies horizontal commonality and finds that all investors share in the risk and the profits of the enterprise.<sup>183</sup> However, this is unlikely to matter for Bitcoin or Ethereum because the factor requiring “profits from the efforts of others” is unlikely to be satisfied for two reasons: (1) the seller has no influence on the purchasers investment success once the investor buys the crypto-asset, and (2) there is no company or management team controlling these crypto-assets.<sup>184</sup> Ethereum is even less likely to satisfy this factor than Bitcoin because of smart contracts and the ability to build on top of the Ethereum platform.<sup>185</sup>

The *Howey* Test is a very fact-intensive analysis, and just because it seems like Bitcoin and Ethereum fail to satisfy it, does not imply other crypto-assets will not. The companies stated above like Protostarr and Slock.it are just two examples of a crypto-asset being deemed a security. More important, Bitcoin and Ethereum are unregulated in the United States today, but that does not mean that they will forever remain unregulated. It is likely that something will be done in the near future to shed some light on what is now a very uncertain space. This is a very exciting and uncertain time for technology, and it will be interesting to see how crypto-assets are dealt with in the near future.

---

<sup>181</sup> See generally IRS NOTICE 2014-21 (Apr. 14, 2014), <https://www.irs.gov/pub/irs-drop/n-14-21.pdf> (explaining the way crypto-assets are to be reported on tax returns).

<sup>182</sup> See *Howey*, 328 U.S. at 297; Long, 881 F.2d at 140.

<sup>183</sup> See *SG Ltd.*, 265 F.3d at 50.

<sup>184</sup> See *Howey*, 328 U.S. at 297.

<sup>185</sup> See Eastland, *supra* note 54.